The Reserve Act in Its Implicit Meaning

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A GREAT banking system could conceivably grow up of itself in response to the demands of business. Such a system would be ideal because of its flexibility and freedom of adaptation to the changing requirements of commerce. But no such system ever did grow up or ever will. A business, involving such an element of trust, is necessarily conducted by human agencies and human agencies are uncertain and often dangerous. Government everywhere, in one way or another, is concerned with banking. It is concerned with the Federal Reserve System which has been evolved or built up around a statute known as the Federal Reserve Act, approved December 23, 1913.

A statute, however, is only a first step toward a banking system which is finally made up of operating banks. These are credit and currency machines whose conduct, in accordance with the law, is guided, regulated and controlled by rules, precedents, traditions, habits, customs, decisions and what not.

The mass of this material makes the system. With this view of banking it is easy to understand why the coming of the Federal Reserve Act did not bring with it the repeal of the National Bank Act. The statute known as the National Bank Act might have been repealed but the act itself is only a part of the national banking system. The rules, regulations, precedents, etc., which make up that system, could, and perhaps should, be codified but anything further would bring uncertainties and throw the entire system into confusion.

As a banking system is composed of a variety of things beside a statute, so the statute itself is the product of a variety of plans, purposes, ideas and theories of a wide range. To get a thorough understanding of a system of any kind, of which a statute is the nucleus, some knowledge of the discussion which preceded its formulation and adoption is desirable and perhaps necessary. Certainly, one ambitious to become expertly familiar with the Federal Reserve System would have to study conditions long before December 23, 1913. The purposes and intentions of the framers of the Act are not told in the Act itself. They are concealed in many reports, documents, and in many minds. They cannot all be told in brief space but discussion of a few outstanding points will perhaps be helpful in view of recent criticism of the Reserve System, newly declared distortions of its purposes and misunderstandings of its meaning.

It may be said on all the authority that exists, that the Reserve Banks are not government institutions, that they were not intended to be, and that any interference with their operations, beyond exercise of the powers conferred on the Federal Reserve Board, is perversion of the law and its meaning as understood and expressed by those who formulated it. The Federal Reserve Banks are privately owned institutions. Their stock is all owned by their member banks. The provision of the law that, in case the banks did not subscribe for the necessary amount of stock, individuals and the government could, has never been acted upon.[1]

[1] Act December 23, 1913, § 2–¶ 29 et seq.

It is possibly true that some members of Congress voted for the bill in the belief that it provided for the establishment of government banks, but it is also probably true that more of them believed that, in some way, the bill opened the way for punishing or demolishing that political phantasy —the "Money Trust." However, what congressmen believe is not evidence.

AN AMENDMENT THAT FAILED

It may be recalled that when the Glass-Owen bill was under discussion in the Senate a serious attempt was made to give the government power over the Reserve Banks by giving the Reserve Board or the Secretary of the Treasury power to appoint a majority of the directors of each bank. Senator Hitchcock of Nebraska offered the amendment, which had other supporters. Members of the banking and currency committees of both Houses were opposed to this amendment. They maintained it was out of harmony with the spirit and purpose of the measure. Chairman Glass of the House Committee and Senator Owen of the Senate Committee were showered with telegrams from all parts of the country, urging opposition to this plan. The amendment failed completely.

Another effort was made to give the government, through the Treasury, direct control over the Reserve Board. This effort had insidious features and was redolent of politics. During the Senate discussion of the Glass-Owen bill, new prints of the bill with minor changes were frequent. In one of these there appeared one day in December an alteration of a paragraph in Section 10, which was made to read, as it still reads, as follows:

> Nothing in this Act contained shall be construed as taking away any powers heretofore vested by law in the Secretary of the Treasury which relate to the supervision, management, and control of the Treasury Department and bureaus under such department, and wherever any power vested by this Act in the Federal Reserve Board or the Federal Reserve Agent appears to conflict with the powers of the Secretary of the Treasury, such powers shall be exercised subject to the supervision and control of the Secretary.

The paragraph was innocent enough in appearance. No one seemed interested in it. Chairman Glass, of the House Committee, disclaimed all knowledge of its source, saying the bill had passed from his control. Chairman Owen, of the Senate Committee was non-committal. He thought the suggestion had come from the Treasury. The paragraph was not discussed on the floor. It passed the Conference Committee apparently without notice. Many other provisions were far more important.

Over a year later, a newspaper item made it known that the Attorney-General of the United States had given an opinion to the President to the effect that the Federal Reserve Board was an independent organization and not a bureau of the Treasury Department. When the President's secretary was queried as to the reason for requesting this opinion, he replied that the President had asked it "for Mac" but did not say whether "Mac" was Machiavelli or McAdoo.

It is not impertinent to point out that, when the Federal Farm Loan Act was on passage, the question of whether the Farm Loan Board should or should not be a bureau of the Treasury Department was fought out. Every form of the bill that came from the House Committee made the Farm Loan Board an independent organization. The Senate Committee invariably made it a bureau of the

Treasury Department. The Senate won. The Farm Loan Board is a bureau of the Treasury Department. The Federal Reserve Board is not.

RESERVE BOARD AN INDEPENDENT ORGANIZATION

The Federal Reserve Board can be classed only as an independent government organization, having supervision over the Federal Reserve Banks and exercising in that field powers defined by law.

The Federal Reserve Banks are privately owned institutions, managed by boards of directors chosen by their stockholders and authorized to function as banks, but within the provisions of law and the rules and regulations made under authority of law by the Federal Reserve Board.

The powers of the Federal Reserve Board are very broad but the great purpose of the law in creating the Board was to conserve the public interest, to provide safeguards against domination over banking by either financial or political interests, and to maintain a sound banking system.

DESIGNED AS AN AID TO BUSINESS

The Federal Reserve System was designed as an aid to business. It is applied only to commercial banking—that form of banking which takes account of the commercial scheme by which commodities are got from producer to consumer. The deposits in commercial banks mark the stored-up purchasing power of the community. Back of their loans are merchantable goods of greater value. Such banks must be liquid. They must pay on demand and their loans must, therefore, be of short maturities. In a general way a loan should run no longer than the estimated time it takes to get the goods behind it to the consumer. In relation to the producer, the jobber may be the consumer; in relation to the jobber, the retailer holds that position; but, in any event, the final consumer must pay because he destroys the goods completely or takes them out of the class of merchantable articles.

Before the Reserve System came to give practical definition to commercial banking, commercial and investment banking were inextricably mixed. The money of commerce in the form of surplus deposits beyond the immediate needs of the owners, or in bank reserves, was drawn to the centers and chiefly to New York where it could be employed in the call loan market: that is, it could be loaned on demand against securities which represent invested capital. That system created all the "Money Trust" that ever existed.

The Federal Reserve System was intended to divorce investment from commercial banking. Notes secured by investment securities are, therefore, ineligible for rediscount. No matter how strong the market demand for such securities, they are not liquid in the sense that commercial bank loans must be liquid. At times they fluctuate widely in price. The call loan rate fluctuates accordingly. In 1907 it reached 125 per cent. An advance in commercial discount rates from 5 to 7 per cent indicates a critical condition in the commercial money market.

The plan to prevent stock market hysteria from affecting commercial business has been reasonably successful. But investment securities have not been kept out of the Reserve Banks. In Section 13, defining paper eligible for rediscount, it is provided that such definition (of eligibility) "shall not include notes, drafts or bills covering merely investments issued or drawn for the purpose of

carrying or trading in stocks, bonds or other investment securities, *except bonds and notes of the Government of the United States.*"

FISCAL AGENTS OF THE GOVERNMENT

The Reserve Banks were intended to be fiscal agents of the government and the exception as to government securities was natural at the time when the World War could not be foreseen. If anyone had thought that the United States would be issuing securities by billions before the Reserve Banks were four years old, it is doubtful if notes secured by government issues would have been made eligible for rediscount so jealous were the framers of the act of the strictly commercial character of the Reserve Banks.

Always uppermost in the minds of those men, both in and out of Congress, was the desire to keep commercial banking and the Reserve Banks free from investment securities. Innumerable proposals have been made for variations from this practice. The trials of war brought many. The farmer's insatiable demand for more capital and credit has been advanced a thousand times. It has been seriously proposed that railroad bonds be recognized as collateral for Reserve Bank loans. The pressure for some departure from the rule has been continual, if not constant.[2]

It is undoubtedly true that many supporters of the Federal Reserve bill in Congress were opposed to investment securities as collateral for notes eligible for rediscount only because of hostility to Wall Street and hatred of the "Money Trust." It is probably true that the distinction between commercial and investment banking was not clear in the minds of all who voted for the bill. But it was clear in the minds of enough. To confine the Reserve System entirely to commercial banking may leave a gap in the banking scheme, but sufficient experience has been had to demonstrate the dangers of any lapse from the integrity of the present plan.

PROTEST AGAINST COMMERCIAL LIMITATIONS ON RESERVE BANKS

The War Finance Corporation was the greatest protest against the commercial limitations imposed on the Reserve Banks. The exigencies of war excused that law, if they did not justify it, but there is substantial ground for the suspicion, if not for the belief, that, underlying the plan for the War Finance Corporation, was the political desire to get for the government some measure of control over investment banking. Many "Money Trust" baiters fondly believed that the Reserve Act would cripple Wall Street. Some thought that control would be given over speculative activities. The War Finance Corporation might have had some such effect if it had functioned to the extent predicted. In its revival as a machine to meet an exigency in which something beyond the maturities permitted for rediscounts under the Reserve Act is necessary, it may fill a temporary need acceptably, but it could not function satisfactorily under other conditions, even if it is conceded that its present operations are satisfactory. On the other hand, it can only be said that, if the Reserve Banks cannot meet every commercial banking need, they are defective. The difficulty lies in determining just what is a commercial banking need. Surely it is not to hold up prices or make up or prevent

[2] The Federal Reserve Board adopted a policy in order to assist in the war financing which was economically unsound. Pages 62 and 63 of the hearings entitled, "Reviving the Activities of the War Finance Corporation."

losses occasioned by cataclysmic disturbances born of war. It is only fair to say that the first duty of commercial banks is to protect themselves. In doing that they protect business. So far as the present operations of the War Finance Corporation protect the commercial banks, the work is probably justified.

SOME THINGS THAT WERE INTENDED

It is not an invitation to controversy to say that the Reserve Act failed to abolish the office of Comptroller of the Currency for two reasons only: one was the political desire to keep the office in existence, and the other, the necessity for retaining temporarily an organization which was familiar with the bank records and had an operating mechanism. Similarly, the Independent Treasury system with numerous subtreasuries was marked for abolition but the work was deferred, as is told elsewhere in this volume.[3]

It was always the plan of the framers of the Reserve Act to secure the ultimate correction of the country's patch-work currency. It was a hard task, and is, with its difficulties increased by the clamors of the many who believe in fiat currency. However, provision is made for the ultimate retirement of both United States notes and national bank currency. A return to stable conditions will permit the execution of these provisions, although little attention has been given them as yet. The purpose of the Act was to give the country ultimately a currency composed of gold and reserve notes, with silver certificates as a sort of necessary evil to supply the demand for small bills. The disappearance of the silver during the War called forth the amendment permitting the issuance of reserve notes and Federal Reserve Bank notes of small denominations. It is hoped that the latter will soon find their way into oblivion.

Reserve Bank notes, of minor consequence in any event, have a significance as a by-product of the note controversy. Like the provision in Section 16 making reserve notes the obligations of the United States—a provision wholly at variance with the spirit of the Act and practically quite meaningless—Federal Reserve Bank notes attested the strength of the "cheap money" element and the desire of the advocates of soundness to avoid a direct test of that strength.

The bond-secured national bank currency and its retirement presented a problem of grave import. It was finally solved by the provisions in Section 18 requiring the Federal Reserve Banks to purchase such bonds, securing circulation, as were offered to the amount defined. Without discussing the methods of refunding and retiring such bonds, it may be said that the fiat money contingent revolted at the idea of having any securities carrying the circulation privilege in the hands of the Reserve Banks without providing a means of issuing notes against them. The means was provided. In due course such notes came into existence. Thus a law which was conceived in the idea that one of its great purposes would be to simplify and unify the currency, actually opened the way for the adding of a new patch and thereby heightening the crazy-quilt effect.

CHECK COLLECTIONS AND NOTE ISSUES

It is in Section 16 under the general title of "Note Issues" that there appears the provision empowering every Federal Reserve Bank to "receive on deposit at par . . . checks and drafts, etc."

[3] See "The Assumption of Treasury Functions by the Federal Reserve Banks."

This and the paragraph which follows were those over which came the bitter controversy between country banks and Federal Reserve authorities. Of the merits or demerits of the arguments which that controversy aroused, nothing need be said here. The only significance for present purposes lies in the fact that "par collections" are provided for in the section devoted to note issues.

Around the question of note issue raged a conflict for many years prior to 1913. The conflict harked back to the Second Bank of the United States, the era when only the states chartered banks and every bank was a bank of issue. It had the savor from Civil War financial struggles; it had been carried through the greenback struggle; it changed its form, not its substance, when free silver was the cry, and it had redivivous whenever elasticity of the circulating medium was mentioned.

The ancient friends of much paper money were reasonably quiet when the advocates of a new banking system talked of the project in terms of bank reserves and credit, but when circulating notes were mentioned they were at home and rampant. Also they had to be dealt with and dealt with kindly and diplomatically. If they should be rubbed against the grain, there was danger that paper currency would be made so pronounced an issue that everything else would be forgotten.

This was the manner of the argument, although argument was a weapon of dubious value in that case: "Checks are the great currency medium through whose use the exchanges of commerce are effected. Elaborate investigation by the Monetary Commission's experts has shown that something between 92 and 98 per cent of all purchases are paid for with checks written against bank deposits. If checks are the chief medium of payment, they serve the purpose of currency which may properly and logically be considered as expressing the same kind of credit in a different form."

The reply to this was that, in such a case, checks should be as good as currency. Certainly they should always be worth par. It was further agreed that elasticity demanded the constant retirement as well as the constant issuance of notes, because checks were instantly cancelled and retired once their work was done. Out of it all came the inclusion of "par collections" in the section on note issues.

However vigorously the subsequent conflict raged, the demonstration of similarity between notes and checks stood secure. The case had been proved, for another purpose perhaps, but proved nevertheless. In vain was it argued that checks are a non-circulating, not a circulating medium. In vain were private rights defended and pleas made that the banker also was worthy of his hire. Par collection stands and perhaps, after all, it was a small price the bankers paid for the relegation of fiat money to the limbo of obscurity.

There have been, of course, many departures from the plans of a reserve system as thought out by its promoters and framers. The making of twelve instead of eight reserve banks, is one instance. In many ways practical experience in operation has overthrown the theories of the system's sponsors. In many others business methods have been gradually altered and habits changed to meet the new banking scheme's requirements. There is much of political interest and much of economic value buried in the history of the struggle for a scientific banking system. A little trip among these buried treasures lets in light on later interpretations of the law. And

despite the tremendous progress made in Reserve Bank operation as the result of war necessities, there were distortions and stretchings of various provisions of the Act. Not yet has there been sufficient experience in times of stable business, to permit a conclusion as to the complete sufficiency of the Reserve System but the foundation has been laid securely. The makers of the law builded well and in the face of very great difficulties.

The Purposes of the Federal Reserve Act as Shown By Its Explicit Provisions

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WHAT were the chief purposes of the framers of the Federal Reserve Act as those purposes are revealed by the explicit provisions of the Act itself? In answering this question it will be well to consider (1) the framework of the Federal Reserve System, namely, its plan of organization and control, and (2) its functions.

The chief contribution made by the framers of the Federal Reserve Act was in the plan of organization they proposed, the functions assigned to the Federal Reserve Banks being essentially the same as those recommended a few years previously for the National Reserve Association of the Aldrich Plan, as well as those of a number of central bank plans still earlier proposed in this country. They are, moreover, not very different from the functions performed by the leading central banks of Europe. In this paper, therefore, attention will be given almost exclusively to the framework of the plan.

REASONS FOR A GROUP OF CENTRAL BANKS

To foreigners who study the Federal Reserve System, the most striking fact about it is that it should have twelve central banks with comparatively few branches, instead of one central bank with many branches. There was nothing like this anywhere else in the world, at the time the Federal Reserve System was created and, so far as I know, there is no historical example of such a group of central banks.

There were two important economic reasons for providing a group of central banks instead of one central bank. These were:

(1) The need of a system that was adaptable to widely different conditions in different parts of an immense country like the United States, with particular reference to rediscount rates, and, (2) the desire to decentralize the control of the American money market in such a way as to weaken New York's alleged domination.

One serious objection to a single central bank in the United States was the difficulty arising from the fact that interest and discount rates for essentially the same kinds of paper usually differed considerably in different parts of the country; rates in the West and South normally ruled higher than those in the Middle West, and rates in the Middle West normally ruled higher than those in New England and the Middle States. It was believed that the establishment by a single bank of